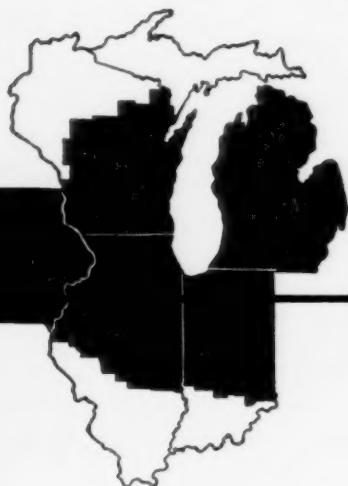


A review by the Federal Reserve Bank of Chicago

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Business Conditions

1958 October



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THE Trend OF BUSINESS

In contrast to two earlier postwar business adjustments, the transition from recession to expansion in 1958 has been crisp and unequivocal. The drop in activity between last fall and last spring was the shortest and sharpest of the past decade. The subsequent recovery has been the most rapid and the most widespread. In short, major indicators have traced a sharp "V" rather than a soft "U" as in earlier adjustments.

Durables join the uptrend

As noted in these pages in earlier months, activity in the Midwest, Iowa excepted, had slumped somewhat further than the nation generally and has shown a lesser recovery to date. This situation stems from the fact that

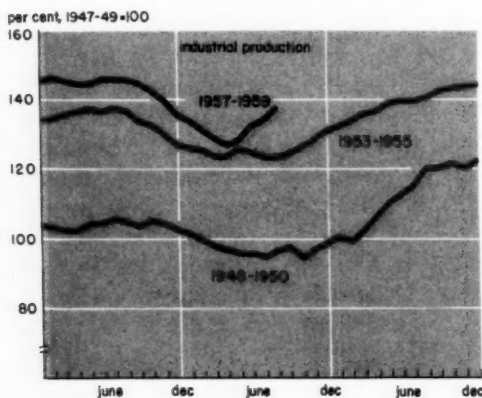
the business decline and the recent turnaround have been associated with rising outlays for consumer soft goods and services, Government procurement and construction. Despite substantial diversification, the well-being of the major industrial centers of this area is tied intimately to the demand for producers' and consumers' durable goods — machinery and equipment, autos, appliances and furniture.

September brought news which suggests that the downtrend in business plant and equipment expenditures has been arrested and may be reversed in the months ahead. This intelligence comes from a number of sources. The SEC-Commerce survey just released indicates that the decline in capital outlays earlier this year was greater than expected, but that a rise may occur in the fourth quarter. The News Week-Conference Board tabulation of "capital appropriations" by manufacturing concerns covering new projects is believed to have shown some improvement in the second quarter after allowing for seasonal influences.

Meanwhile, new orders for various individual categories of capital goods are trending upward. The improvement has been most marked in construction machinery, but machine tools and a variety of other goods, even including some types of railroad equipment, also are reported to be doing better.

The change in the capital goods outlook is in sharp contrast to the view commonly held earlier in the year that business would con-

Steepest postwar recession has been followed by sharpest recovery



tinue to reduce such spending for several more quarters at least. Substantial "excess capacity" in basic industries such as steel, aluminum, glass and cement were thought to make this inevitable. Now it appears that many capital spending programs, shelved temporarily in 1957 and early 1958, are being reactivated and some new plans are being initiated.

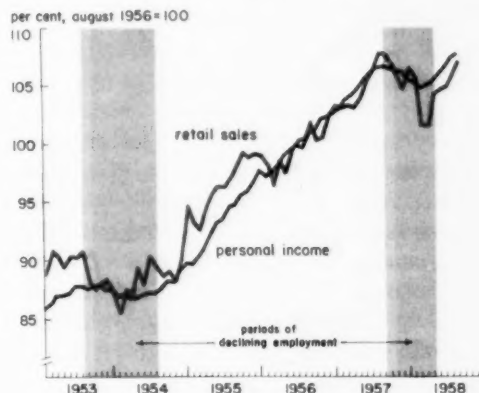
The indicated rise in capital spending doubtless will be of moderate proportions compared with the 50 per cent gain from early 1955 to early 1957. It will feature projects one or more steps closer to the final buyer than basic materials. The emphasis will be on new products, cost-cutting installations and better locations.

In the case of consumer hard goods, the picture has not firmed as definitely as for producers' durables. New car deliveries during the summer remained 30 per cent below 1957, about the same as in the year-to-date comparison. Sales of furniture and appliance stores in July remained 3 per cent below year-ago levels. However, production of appliances and furniture began to rise markedly in June and July. But in large part this was an inventory phenomenon. Dealer holdings of some items had been allowed to fall below comfortable levels.

Nevertheless, there are good reasons to believe that consumers will begin to show a greater willingness to buy big-ticket items in larger quantities. Their hesitation on large outlays has been based upon the same psychology as that of the businessman — caution in making new commitments until clearing economic skies suggested grounds for a more confident attitude. Their ability to buy is greater than ever.

Personal income in August was estimated to be at an annual rate of 356 billion dollars, $3\frac{1}{2}$ billion or 1 per cent more than a

Consumer buying power at new high, retail sales approach 1957 record



year earlier. Last March personal income was the first major business barometer to reverse its decline, and it moved to new all-time highs in the summer. Few other measures have made up much more than half of their 1957-58 dip. Meanwhile, instalment credit has been paid down somewhat on a seasonally adjusted basis since last January.

Some reservations

Of course, the economic weather forecast, as always, contains warnings of possible squalls. Three principal clouds have been noted. They include the stubborn unemployment situation, the sharp advance in long-term interest rates which could dampen the upsurge in home building and the possibility that important work stoppages may arise out of current labor-management disputes.

Unemployment is estimated to have declined in July and August but not as much as might have been expected seasonally. In fact, the 7.6 per cent of labor force, seasonally adjusted rate, for August was the highest for the year. Moreover, new claims

for unemployment compensation in August were still 50 per cent greater than last year for the nation. Michigan, Wisconsin and Indiana reported much larger increases.

The unemployment situation usually moderates slowly as the economy picks up speed. It is in a period such as the present that labor force efficiency and output per man and per man-hour improves most rapidly. Nevertheless, ever since April seasonally adjusted wage and salary employment has been moving up steadily — about as fast as in the same period of 1954 at which time the economy was also recovering from a mild recession.

Higher interest rates, thus far, have not

slowed the rise in housing starts which hit a two year high in August. In the Midwest, rates on new mortgage loans are on the rise again and FHA mortgages once more are moving at discounts, but mortgage money remains generally available. Meanwhile, there is no evidence that higher money rates have greatly affected the improvement in the prospects for capital expenditures.

The possibility of a serious strike in the automobile industry may have been averted with the signing of a new UAW-Ford pact in mid-September. This agreement could presage a less stormy period for labor-management relations than many observers had expected.

State-local capital outlays: still high and rising

At its outset, the now-fading recession commonly was alleged to be a "capital spending recession," akin to those of pre-war years and unlike the two prior postwar declines in business activity. If this proves in retrospect to have been the case, state and local governments have not contributed to the decline.

As in the 1948-49 and 1953-54 declines, public agencies on the state and local level have continued to increase their outlays, for both current and capital purposes, posting new records each quarter and each year. By mid-1958, the proportion of the nation's output of goods and services absorbed by state-local governments had passed the 9

per cent mark, a proportion not seen for more than twenty years. In the immediate future, the rise will continue to be large, in both absolute and relative terms. Capital outlays in particular will climb, as the road-building plans stimulated by the 1956 Federal legislation increasingly reach the spending stage and the record volume of new municipal bonds sold this year are translated into actual construction work.

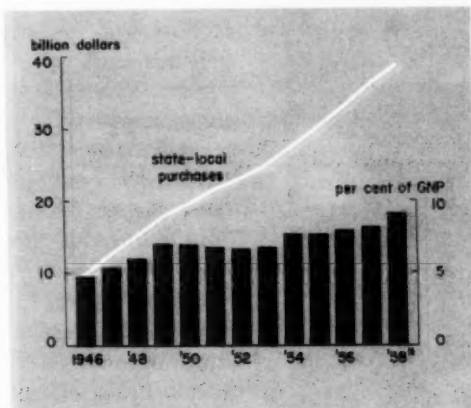
The recession record

In the second quarter of this year, gross national product reached a seasonally adjusted annual rate 16.6 billion dollars below its peak level of the summer of 1957. In

part, last winter's pessimism about the course of the economy was due to the pervasiveness of the decline. In contrast to the earlier postwar recessions, nearly all major sectors of the economy contributed to the drop in spending — consumer durables, producers' durables, business inventories, private construction and Federal purchases of goods and services for national security purposes. Spending for goods and services increased in only three areas — consumer services, Federal nondefense programs and state and local activities. The latter rose from a seasonally adjusted annual rate of around 36 billion dollars to around 39 billion.

During a short-lived recession, or in the initial phases of a more protracted one, state and local agencies find it easy and advantageous to accelerate their capital spending programs. Funds are at hand and more bidders compete, at favorable prices, for the construction work. State-local construction spending since the third quarter of 1957 is

Postwar climb in state-local spending faster than in GNP



*First half, annual rate.

estimated to have increased nearly 1 billion dollars, from a rate of around 9.5 billion to around 10.5 billion. Construction spending thus is a rising share of state-local outlays.

Outlays for new construction at the state-local level are now about nine times as great as in 1946. They are more than twice as high as in 1949, which was probably the first year in which public agencies were fully tooled up with the legislative authority, plans and engineering staffs needed to make a dent on the accumulated needs for new public facilities following World War II. In real terms, construction activity is about four and a half times the 1946 level and about two-thirds greater than in 1949.

This is part of the postwar trend in spending by America's "grass-roots" governments. No other major sector of the economy has expanded so rapidly since 1946, in part because no other major sector confronted so large a backlog of unsatisfied requirements at the war's end. State and local purchases of goods and services are now running at a rate about four times as high as in 1946, which represents an average annual increase of about 12.5 per cent compounded. Seasonally adjusted, state-local purchases have increased in every quarter since the beginning of 1946, save for two — one in which outlays were unchanged and one in which they declined only slightly. The characteristic increases have been around 2.4 billion dollars annually. More recently, since mid-1956, state-local purchases have been rising at an annual rate of more than 3 billion dollars, with highway construction outlays apparently accounting for about 40 per cent of the increase this year. During the postwar years, inflation has boosted state and local government costs a good deal more than those confronting the private sectors of the economy, but even in physical terms the ex-

pansion of state-local activity has been large: it more than doubled since 1946, increasing at an average annual rate of approximately 7 per cent compounded, about twice the rate of increase in real gross national product.

Although state and local governments continued to increase their outlays in this as in the two previous postwar recessions, they did so at the expense of a considerable deterioration in their over-all financial situation. In none of the three recessions did total state-local receipts decline. Rather, the rate of increase slackened. Postwar prosperity — and price inflation — together with higher rates of existing taxes and adoption of new tax devices have resulted in large year-to-year increases in state-local revenues, almost but not quite matching the increase in ex-

penditures. In the recession years, the smaller than expected increases in revenues and the specter of potential declines led to unusually widespread flurries of tax rate increases. But since the recession proved short-lived, these tax rate increases had their greatest impact on revenues in the prosperous months and years thereafter.

For example, in 1953, on the accounting basis used in the official national income figures, state and local units had an over-all surplus of about a quarter of a billion dollars. But in 1954, spending increased nearly 3 billion dollars, almost twice as much as receipts, and state-local borrowing had to cover an over-all deficit of about a billion dollars. In 1955, expenditures and receipts increased equally rapidly, as economic recovery began

to affect state-local revenues. In 1956, however, the impact of renewed prosperity was fully apparent for receipts rose almost a half billion dollars more than expenditures, and the over-all deficit was only half as large as in the two previous years.

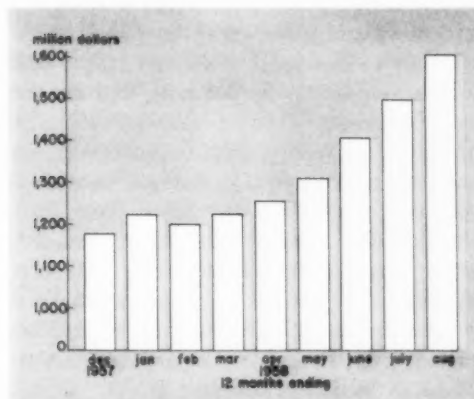
Since the 1957-58 recession proved to be somewhat deeper than the earlier ones, the slackening in revenues has been sharper. State-local receipts rose less than 1.5 billion dollars (at annual rates) from mid-1957 to mid-1958, in contrast to a rise of nearly 4 billion dollars in the

The composition of state-local capital outlays

	1957 amount ¹ (billion dollars)	Distribution (per cent)	Change 1952-1957
Total	12.6	100	+40%
Type of outlay:			
Construction	10.4	82	+35%
Land and existing structures	1.2	10	+10%
Equipment	1.0	8	+10%
Activity for which spent:			
Education	3.3	26	+25%
Highways	5.3	42	+20%
Water supply .....	.8	6	+10%
Sanitation .....	.7	5	+10%
Electric power systems ..	.5	4	+10%
Hospitals .....	.3	3	+10%
Housing and community development .....	.3	2	+10%
All other	1.5	12	+10%

¹U. S. Census Bureau data, which are somewhat larger than Labor Departments' estimates used in the initial part of the article.

Federal highway aids rise rapidly in recent months

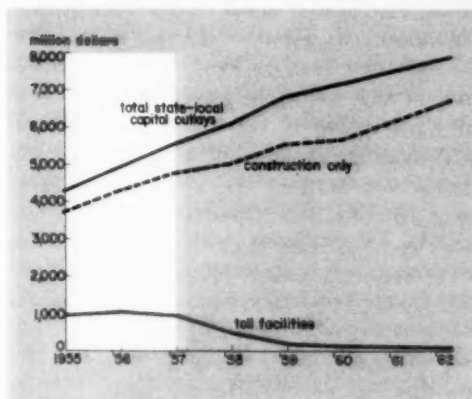


preceding year. Since spending continued to rise rapidly, the over-all position deteriorated greatly — from a deficit, at annual rates, of around a half billion dollars in the third quarter of 1957 to one of around 2.5 billion in the second quarter of 1958. On balance, the larger deficit faced by state and local governments cushioned a significant portion of the decline in the rest of the economy.

Land and equipment

The share of the state-local capital outlay dollar devoted to nonconstruction purposes — the purchase of sites, right of way, and existing structures and the equipping of new facilities — has grown in the last few years. Site costs were relatively low in the initial postwar surge of state-local capital spending programs, in part because most of the road-building activity occurred in rural areas where land acquisition costs are low or took the form of rebuilding old roads along existing right of way. Also, some of the new

Steep climb in highway capital spending forecast



building occurred on sites acquired years earlier, before the war. More recently, however, road building has been increasingly concentrated in urban areas, where land costs, particularly for the huge swaths cut by new expressways, are enormous and rising. Moreover, land costs in suburban areas, where much of the capital spending for other than highway purposes occurs, have been rising steeply. Furthermore, the types of projects which have been favored in the last few years entail sizable equipment purchases, particularly for the utility-type activities of state and local governments.

In 1957, state-local outlays for capital purposes aside from construction reached nearly 2¼ billion dollars. This was more than double the level of five years earlier, in contrast to a 63 per cent rise in construction expenditures. Expenditures for equipment passed the billion dollar mark for the first time. Although state and local governments have always been an important ele-

ment in the demand for the resources employed in construction, in the past they have been a negligible factor in the demand for durable goods. In 1952, for example, expenditures for the purchase of consumers' and producers' durables totaled about 50 billion dollars and state-local equipment purchases about 600 million. Five years later, durable purchases by the private sector of the economy had increased about one-third but those by state-local agencies more than three-fourths. In mid-1958, with depressed levels of private spending for durables, state-local equipment purchases were relatively about twice as important as in 1952.

The months ahead

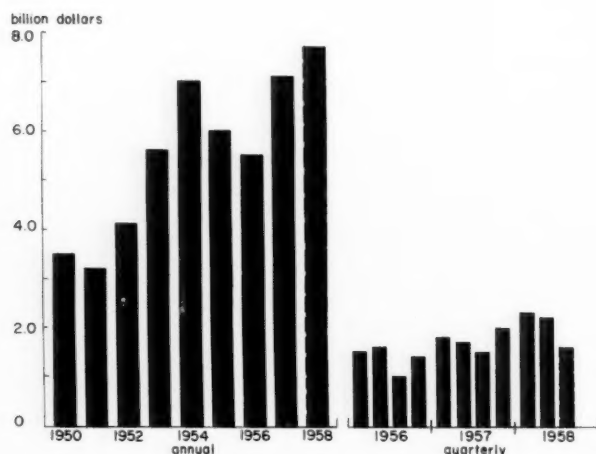
There are signs that the long rise in state-local capital spending will accelerate in the immediate future. For one thing, construction contract awards for the types of work in which state and local agencies are the most important factors have been running substantially ahead of the high levels of a year

ago. In the first seven months of 1958, contract awards for all types of public construction projects were 15 per cent above awards in the same period of last year. During the summer months, the gap over a year earlier widened — in June it was about 30 per cent and in July nearly 55 per cent. In June and July, increases of more than 25 per cent above 1957 were recorded in contracts for work on roads, sewerage systems, water supply facilities, airports and public administration buildings. Increases, although of smaller proportions, occurred in nearly all other categories of state-local construction. Since these are contract awards, not work completed, it is all but certain that actual construction activity will rise steeply during the next six months at least.

To go one stage further back in the process by which community needs are reflected in finished public works, bond sales by state and local governments to finance new projects have been at record levels this year. Issues sold for new capital in the first

three quarters of the year totaled more than 6.1 billion dollars, compared with less than 5.1 billion last year, the previous record year for municipal flotations. The high volumes this year and last have been reached despite the virtual disappearance of large-scale toll road financing, which had been responsible for the earlier peaks in new issues back in 1954 and 1955. In recent months, school issues have been the pace-setters. While school construction activity and contract awards have been only modestly above the 1957 levels recently, the bond sales suggest a spurt in the near future.

Record state-local bond sales



The biggest push will come from the function which looms largest even now in state-local capital spending — road building. Much to the disappointment of the construction industry — and motorists — the greatly expanded program of Federal aid for highways enacted in 1956 has been slow to be noted in increased highway construction outlays. State-local highway construction spending rose only about 10 per cent in 1957 and is expected to rise only about 5 per cent this year. In part this is because of the virtual ending of the toll road construction boom, which in 1955 and 1956 accounted for nearly one quarter of all road building work. In 1957, the decline in outlays for toll roads partly offset the increase in work on Federally aided projects and this year is expected to completely offset the increase in Federal aid construction work. Also, a substantial portion of the increased outlays on projects included in the Federal aid program has been for acquisition of right of way and preliminary engineering work.

With much of the preliminary work now done, and with the impetus of the 1958 amendments to the Federal legislation which will induce substantially larger outlays during the next two years than might otherwise

have occurred, highway spending is starting its long-awaited steep climb. One symptom of this is expenditures from the Treasury's highway trust fund. During the twelve months ending December 1957 they totaled less than 1.2 billion dollars. During the year ending this past August, they exceeded 1.6 billion dollars, a one-third increase.

In a forecast issued during August, the Bureau of Public Roads estimated total state-local highway capital outlays for 1959, including those on road projects not eligible for Federal aid, at nearly 6.9 billion dollars, up more than 800 million dollars from this year's estimated level; construction expenditures were set at nearly 5.6 billion dollars, up nearly 600 million. By 1962, the Bureau expects highway construction spending by state and local agencies to reach 6.7 billion dollars and total highway capital spending to reach 7.9 billion dollars. In all, it seems likely that capital spending by state and local governments may show gains averaging close to 1.5 billion dollars annually during the next four or five years. The pressure on state-local fiscal resources and, more fundamentally, the demand for more of the nation's physical resources to meet community needs, will therefore continue unabated.

Tough question for cattle feeders

A vigorous demand for their product and a great abundance of the resources needed to produce it: this is the situation the nation's cattlemen are facing. What, it may be asked, could be more favorable? Can such an environment really present difficult questions?

The abundance of the resources needed to produce beef is exceptional if not unprecedented. The nation's major grazing areas have been plush with grass. Nearly all areas are reported to have abundant pasturage, which in September "averaged na-

tionally the best since 1942." Hay is stacked higher than usual in most areas this fall. The USDA's hay crop estimate has been increased to "within 2 per cent of last year's record tonnage as late cuttings flourished almost to the unneeded stage in many fields."

And the Corn Belt's "golden grain," although maturing slowly because of cool weather in some areas, is headed toward an estimated national harvest of 3.6 billion bushels, 5 per cent more than last year and 14 per cent more than the 1947-56 average. Total production of *all* feed grains now seems likely to surpass last year's record by nearly 6 per cent. In addition, the carry-over of feed grains from previous years' harvests is estimated at 61 million tons, nearly twice the 1952-56 average carry-over. Finally, the supply of high protein feeds — mostly by-products of the oil seeds — will be superadequate, as indicated by the record soybean crop and the gains over year ago in output of cottonseed, flaxseed and peanuts. Thus, there is an abundance of feed to support a higher output of beef, and the supply of other resources — including labor, credit and physical facilities on farms and ranches — also is capable of handling a larger number of cattle.

The demand for beef has shown every indication during recent years that American consumers were developing a strengthened and persistent preference for this commodity. Even during the months of rising unemployment and pessimistic job prospects in the past winter and spring, consumers continued to spend aggressively for beef and to force prices to higher and higher levels. And now, with business activity picking up and employment showing a gradual rise, demand for this luxury protein is expected to continue strong.

Yet the present balance in the cattleman's

favor is a delicate one. Although the demand for beef is strong and growing, it is somewhat inelastic. That is, any sudden increase in supply of beef is likely to be purchased by consumers only with some concession in price, and typically the price concession is greater than the increase in marketings. This means larger marketings bring less total income and much less net income. Thus, production initiated in response to today's prices may materialize under a less favorable price and income situation.

The problem of price uncertainty is especially important to Corn Belt farmers who typically purchase feeder cattle in the autumn and fatten them for market during the ensuing year. Since the weight of the animal when purchased is usually about two-thirds the weight of the animal when sold, cattle feeders have substantial exposure to price changes, and it is the uncertainty as to prospective prices and profits which lies at the heart of the tough decisions confronting cattlemen in the autumn, 1958.

Modest profits in prospect

The profit margin for a typical seven-month cattle feeding program last winter and spring was highly favorable. Yearling feeder steers, 500-700 pounds, averaged about \$21 per 100 pounds at Kansas City from September to November last year while choice grade slaughter steers at Chicago brought an average of nearly \$29 per 100 pounds from April to June 1958, an increase of \$4 from last fall. Thus, the margin (spread between purchase price as a feeder and sales price as a fat steer) of nearly \$8 per hundred on the purchased weight of, say, a 650-pound feeder animal would amount to about \$52. This assured profitable cattle feeding.

Furthermore, feed grains, the major cost in cattle feeding aside from the purchase of

the feeder animals, were relatively cheap as compared with the price of choice slaughter steers. Hence, the cost per pound of adding the approximately 350 pounds to the weight of the steer during the "fattening" process was less than the selling price per pound of the fat steer. This further augmented the profit possibilities for Corn Belt farmers and provided high returns — about \$75 per head — from this hypothetical but more or less typical program in the past season. Only in 1949-50 and 1950-51 were returns more favorable in recent years.

Current prospects, however, appear to be quite different. Yearling, feeder steers at Kansas City averaged about \$27 per 100 pounds the first week in September this year. The concurrent price of choice slaughter steers at Chicago was also about \$27. This unusual price relationship indicates far from favorable profit prospects in cattle feeding.

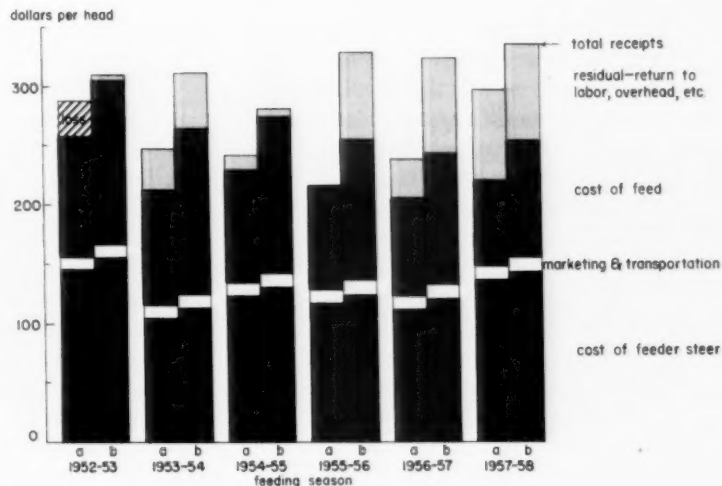
Assuming the same costs for feed, marketing and transportation as in the past year, and assuming further that choice slaughter steers can be sold for \$27 per 100 pounds next spring, only about \$14 per head would be available to cover labor and overhead costs. This is substantially below the average of \$33 for the last 10 years.

A tough question this fall: can Corn Belt

Financial results of feeding programs

a—"good" 650-pound steer purchased September-November; sold the following April-June.

b—"good to choice" 650-pound steer purchased September-November; sold the following July-September.



farmers expect prices for fed cattle to return to the high level of early 1958, or will lower prices turn the feeding operation into a losing proposition? The question is especially ominous when cattle prices appear to be at a relatively high level and, therefore, exposed to possible decline, and when feeder cattle prices are high relative to fat cattle at the beginning of the feeding season.

The price for fed cattle next year depends on a number of factors. Very important is the number of such cattle slaughtered. Possibly of equal importance is the number of grass cattle slaughtered as these affect the total supply of beef although they typically do not yield beef of top quality. Important also is the supply of competing meats such

as pork and poultry. While short supplies of pork this year helped boost beef prices, much larger supplies of pork are in prospect next year, possibly on the order of 15 per cent or more. And, poultry supplies are expected to continue at high levels. Finally, the demand for beef, as indicated above, is expected to continue strong.

While Corn Belt farmers may individually decide whether to expand their cattle feeding operation, the over-all supply of feeder and stocker cattle available for feeding is not so clearly within their control. The calf crop in 1958 is slightly smaller than last year and has declined for four years. In addition, the abundance of grass and hay in grazing areas has caused many ranchers to cut back somewhat on their marketings and has caused other ranchers to purchase cattle for herd expansion which normally would move to feedlots and slaughter. Indeed, the major key to the whole beef supply-price picture next year appears to lie in the decisions of cattle breeders to market currently or to withhold cattle for herd expansion.

Restocking under way

When the inventory of cattle on the nation's farms and ranches is taken next January 1, it will likely show an increase over the year-earlier number. If this proves to be correct, the recent downswing in number of cattle will have been the shortest on record — just two years' duration. And the decline will have been the smallest — dropping just 3 per cent — from 97 million January 1, 1956, to 94 million January 1, 1958. By way of comparison, the number of cattle on farms declined 10 per cent in the previous downswing which extended from 1945 to 1949.

Once an upswing in the number of cattle on farms and ranches gets under way, it tends to be self-reinforcing and to continue

for several years. The withholding of cattle from current slaughter boosts beef prices and encourages further herd expansion. "Because insufficient time has elapsed for breeding herds to be enlarged, cattle slaughter will probably not differ a great deal in 1959 from 1958," according to the U. S. Department of Agriculture.

Old man weather holds key

The turning point of the present upswing can be dated from the drought-breaking rains in the Great Plains in 1957, followed by one of the best grass years in memory in 1958. Thus, old man weather rears his formidable head and further complicates the cattle picture. Prices next year, even for fed cattle, apparently will depend heavily on weather and its influence on ranchers' decisions to rebuild or liquidate herds. Assuming normal weather and the continued withholding of cattle for herd expansion through 1959, Department of Agriculture experts say, "Prices of fed cattle during much of next year are likely to be about as high as this year."

In the longer outlook the willingness of cattlemen to expand production is reflected by their current actions to rebuild breeding herds. Their ability to expand production, however, is dependent on two processes of nature — one predictable and the other unpredictable. The predictable is concerned with the biology of the bovine. A beef cow retained this year means an extra calf next year which in turn takes eighteen months or more to be ready for market. Thus, *if the unpredictable processes of weather permit ranchers to continue herd rebuilding*, the time schedule imposed by nature means that decisions this year to increase production will not result in any substantial additional slaughter of cattle in 1959.

Some farmers are delaying the purchase

of feeder cattle this fall hoping for lower prices when snow blankets the western grazing area. And some are making shifts in the kinds of feeder cattle purchased or in the time of year they plan to market their fat cattle, but such adjustments may be largely offsetting. Finally, a few may decide to stay out altogether, and these, along with those

who decide to go ahead but on a reduced scale, will help to assure somewhat more favorable results to those who do not retrench. Most farmers, nevertheless, will "do the inevitable" — they have all the resources needed to engage in cattle feeding and will use them, although possibly not so fully as if the profit outlook were more attractive.

Small business investment companies

The session of Congress recently ended has been termed "a high-water mark for legislation benefiting the nation's small business concerns." This characterization is based on the enactment of a number of individual laws, including those which made the Small Business Administration a permanent agency, lightened the tax obligations of smaller firms and their owners, and liberalized Government procurement procedures on minor purchases. Greatest interest, however, has centered in the Small Business Investment Act which provides for Federal aid to specialized investment companies.

In Congressional hearings during the past year, one point of view found expression again and again; namely, that small and growing business firms have adequate access to short-term credit. If a gap in the credit structure exists as regards small business, many statements suggest that it concerns lack of facilities for providing long-term loans and equity capital. This type of capital is commonly obtained by larger firms from

the sale of stocks and bonds through the organized capital markets.

Virtually every year since the end of World War II, bills have been introduced in Congress which called for the creation of small business "capital banks" of one sort or another. These institutions were proposed to improve the availability of equity capital and long-term credit to small businesses. In some cases, the institutions proposed would have broadened the scope of the lending and investment function performed in recent years by the SBA and by its predecessor, the Reconstruction Finance Corporation.

Following competition for loanable funds in the 1955-57 period, interest in the proposed capital banks for small business reached a new high during the past year. Numerous bills were introduced, some of which contained novel departures from existing financial arrangements.

The act

The provisions of the act finally adopted

place relatively less emphasis on Government aid and relatively more upon private enterprise and local initiative than many of the other proposals considered. Nevertheless, it marks a significant departure from the small business legislation of the past in that it makes a definite although indirect attempt to augment ownership capital.

As is common with new legislation, it will be some time before the full ramifications of the act are clear. Responsibility for its administration is lodged with the SBA which must formulate administrative regulations. These regulations will determine the actual character of the program to a considerable degree and will help to clarify many of the features not spelled out in detail in the law.

Essentially, the act provides for making Federal money available to investment companies which will in turn lend to small firms. Federal charters may be issued to such institutions, but only if it is determined that a charter cannot be obtained in the individual states.

Whether state or Federal charters are employed, the SBA will issue licenses to approved institutions. These licenses are required not merely to obtain Federal money under the program but also to receive the benefits relating to taxes and regulation of securities which are provided by this act and other new legislation. According to the SBA, application forms and copies of regulations will be ready about mid-November. It is expected that some investment companies will be functioning by year end.

Obtaining funds

Investment companies must have paid in capital of at least \$300,000 to operate under the act. Half of this amount must be provided by the stockholders of the enterprise. The SBA may then invest another \$150,000

in the form of subordinated debentures — long-term debt which will rank ahead of common stock but behind other indebtedness in case of liquidation.

These debentures are to be considered capital for the purposes of the act, although they will bear a stated rate of interest — 5 per cent according to an SBA announcement.

In addition to supplying half of the \$300,000 capital, the SBA is authorized to lend up to \$150,000 to these firms. It would be conceivable, therefore, for an investment company to have \$450,000 to lend, of which two-thirds was supplied by the Government. It could obtain additional funds by selling more stock or borrowing from other lenders.

Government loans to individual investment companies will have to be repaid in time. The \$250 million made available to the SBA for lending to investment companies is intended to operate as a "revolving fund."

Who may organize?

A minimum of ten stockholders may organize a SBIC. There is no requirement, however, that each individual or corporation stockholder contribute any minimum sum to the enterprise. Thus, one stockholder apparently could supply virtually the entire \$150,000 required to start a SBIC.

Thousands of inquiries have been received by the SBA from parties interested in the new plan. Many of these have come from banks, savings and loan associations, insurance companies and other financial institutions, as well as chambers of commerce and similar local promotional groups.

National banks and state-insured banks, unless prohibited by state law, are permitted to invest 1 per cent of their capital and surplus in the stock of one or more SBIC. Thus, a bank with capital and surplus of \$15 mil-

lion might organize such a company as a subsidiary.

It has been pointed out that the act modifies in some degree the terms of the divorce of commercial and investment banking which was decreed by Federal statute 25 years ago. Presumably, a commercial bank will be authorized to lend to a SBIC subsidiary subject to regulatory restrictions. Through this institution it could, in effect, invest in the stocks of eligible, small business corporations, which it could not do otherwise.

It is to be expected that existing financial institutions, commonly, will be the organizers of investment companies. Financing small business is a difficult process which can be both time consuming and costly. Existing financial institutions are equipped to handle the overhead of investigation and administration along with their regular operations. Moreover, they will often be in a position to know which firms can benefit from the type of financing which the new investment companies are expected to provide.

Various restrictions are placed on investment company lending by statute, and others can be imposed by SBA regulation. The total funds which can be made available to a single firm, for example, cannot exceed 20 per cent of an investment company's capital and surplus. Also, funds can be made available *only* in the form of loans or through the purchase of convertible debentures. In addition, the SBA is empowered to place interest rate limitations on loans and upon the size of borrowers. Also, it may make examinations of the investment companies and require them to file reports. SBA officials indicate that they will be as liberal as possible in regulating investment company operations.

A boon to borrowers?

The Small Business Investment Act is in-

tended to stimulate "the flow of private equity capital" to small business. However, it does not provide for direct equity investment. Rather, the investment companies may purchase debenture bonds from small business concerns which are to be convertible at a later date into common stock. It is possible, of course, that the additional provision for debt financing might also help attract ownership capital to a small firm from other investors.

Before providing "capital" to a small business concern, the investment company may require that any or all of existing indebtedness should be refinanced. Prior approval is to be obtained before a firm can incur additional indebtedness.

Investment companies are also authorized to make loans to small business concerns. In addition, they may participate in loans made by other lenders. Maturities on loans may range from 5 to 20 years with a possibility that a 10-year extension may be obtained at the end of that time. These loans will be "of such sound value or so secured as reasonably to insure repayment."

It would seem that many small firms would prefer outright loans to the sale of convertible debentures. The convertible feature is mainly of value to the investor. Conversion would take place only if the firm became successful. At such a time the original owners of the small business might be averse to sharing ownership and control. In case of financial difficulty, the debentures constitute debt which must be serviced and eventually repaid.

Unless the interest rate on loans is substantially higher than the rate on debentures, small firms probably would tend to avoid the latter, assuming the alternative is available to them. Another consideration springs from the difficulty of determining the value of the

stock of a firm which does not have a ready market.

Recently the administrator of the SBA stated that there was no immediate intention to restrict the charges to be made by investment companies and implied that existing state usury laws would set the maximums. But it would appear that these rates would have to bear some relation to the 5½ per cent charged by the SBA itself on loans to small businesses. The SBA continues to have the power to lend money to small firms. It can grant loans which range up to 10 years in maturity and these can be extended an additional 10 years if conditions warrant. In practice, the SBA has usually kept maturities well below the 10-year maximum.

Can loans other than mortgage loans be extended for 10, 20 or 30 years to small firms without undue risk even at high rates of interest? Can restrictive covenants and provisions which accelerate the maturities of loans be held to a minimum that will not hamper the freedom of movement of the debtor or, indeed, break down the dividing line between short-term and long-term debt? Satisfactory answers to these questions must be visualized if the new program is to become an important adjunct to the existing financial institutions and practices.

An experiment

The contribution which the Small Business Investment Act may make to a more efficient financial mechanism will be determined only with the passage of time. From the standpoint of small firms seeking funds, the program can be helpful since it adds an additional source of funds.

For the potential investor the SBIC plan offers a new outlet for funds. Of course, it has been and continues to be possible to set up investment companies independent of the

recent authorization. If the object of an investor is profits rather than building good will or promoting local expansion, he must decide whether the advantages of the plan, including tax benefits and the availability of Government money at relatively low rates, outweigh the disadvantages. These include the restrictions on lending methods and the selection of borrowers, together with the possibility that interest rates may be controlled and that other restrictive SBA regulations may be forthcoming.

The ability of investment companies to obtain additional debt financing will determine to a large extent the profit potential of these enterprises. Finance companies in good standing can borrow two or three times their capital, including subordinated debentures. SBIC's operating in a new medium of business finance may have to be content with far less leverage than this. Their ability to attract additional outside funds will be determined largely by the confidence of lenders in the management of individual institutions.

The SBA in formulating its regulations will attempt to encourage investment in the proposed investment companies by avoiding unnecessary restrictions. Nevertheless, lenders whose operations are based in part upon Federal money must expect some limitations on their activities.

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